The Tax Adviser

A walk through the step-transaction doctrine

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EXECUTIVE SUMMARY

- The IRS may apply the step-transaction doctrine, a rule of substance over form, in a variety of taxpayer circumstances to deny tax benefits derived from a series of transactions that should more properly be treated as a single transaction.
- The courts have developed three tests to analyze whether the step-transaction doctrine applies to a series of transactions: the end-result test, the interdependence test, and the binding-commitment test.
- Under the end-result test, if the separate transactions were component parts of a single transaction intended from the outset to produce the ultimate result, the step-transaction doctrine would apply.
- Under the interdependence test, the step-transaction doctrine applies if a series of transactions are so interdependent that, without completion of all the transactions, the individual transactions would have been fruitless on their own. Under the binding-commitment test, which is seldom invoked, the doctrine applies if, at the time of the first transaction, there is a binding commitment to complete all the transactions.
- Because many transactions that are valid for tax purposes may be accomplished in stages, taxpayers should be aware of limits on the step-transaction doctrine and ensure that each step has economic significance independent of the others.

The economics surrounding the COVID-19 pandemic may be causing many taxpayers to enter into transactions to preserve capital and reduce financial risk. The IRS may challenge the validity of transactions that appear primarily motivated by tax considerations. To best defend a taxpayer's reported tax treatment of a series of transactions, taxpayers and their advisers should understand the possible grounds for a challenge of that treatment. The IRS frequently attempts to recharacterize a series of separate transactions as a single transaction for tax purposes based on the step-transaction doctrine. An overview and analysis of the step-transaction doctrine's application should enable more secure and efficient tax planning and aid an informed judgment of the strength of the IRS's position if it invokes the doctrine in a challenge to the taxpayer's treatment of a series of transactions.

The step-transaction doctrine is a rule of substance over form. It "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[1] Whether the doctrine applies is a question of fact.[2]

Impact of application

If taxpayers arrange to meet all the statutory requirements for each of a series of transactions but manipulate either the economics or the timing of the transactions to obtain favorable tax treatment, the IRS may be able to apply the step-transaction doctrine to deny the taxpayer the favorable tax benefits Examples where the IRS has successfully used the doctrine include:

- Loan and option transactions under the guise of a reorganization and financing arrangement constituted the sale of a partnership interest (from nontaxable to a taxable transaction).[3]
- Impermissible attempts to create amortizable term interests out of nondepreciable property (amortization deduction was disallowed).[4]
- A parent's sale of its 80% owned subsidiary to another company, which was followed by the parent corporation's repurchase of all of the subsidiary's assets except the assets of a single grocery store (loss was disallowed).[5]
- Advance royalty payments under nonoperating coal leases were allowed as deductions from ordinary income only if the taxpayer's intent was to mine coal at the time that he entered into the leases (deductions under Sec. 631(c) disallowed).[6]
- Lease-stripping transactions as multiple-party transactions intended to allow one party to realize rental income and to allow another party to report deductions (improperly separated income from related deductions, and, thus, the tax consequences of the deductions were disallowed).[7]
- Transfers of a corporation's stock by stockholders to a second corporation in exchange for stock of the second corporation, cash, and notes, followed by the merger of the first corporation into the second corporation, were a tax-free reorganization under Sec. 368(a)(1)(A). Thus, the transfer of the stock, cash, and notes was found to be a distribution of a dividend (in the amount of the cash and notes) rather than a sale of the stock, cash, and notes.[8]

Three tests for determining if the doctrine applies

As the Tax Court stated:

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged.[9]

The courts generally have used one of three tests to determine whether the step-transaction doctrine should be applied to a series of transactions: the end-result test, the interdependence test, and the binding-commitment test. However, courts have seldom applied the binding-commitment test, which requires that there be a binding commitment at the time the first step was entered into to take the later steps claimed to be part of a single transaction.[10]

End-result test

Under the end-result test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[11] "A prerequisite to application of the end result test is proof of an agreement or understanding between the transacting parties to bring about the ultimate result."[12] Thus, to avoid the application of the step-transaction doctrine under the end-result test, the taxpayer should show that there was no agreement or understanding among the parties to cause the ultimate result of the transaction.

In addition, where a taxpayer is the sole shareholder of the involved entity, the Tax Court requires a "firm and fixed plan" to bring about that result: "If the taxpayer is the sole shareholder of a closely held corporation and could easily change his mind regarding the implementation of the alleged plan, this Court has demanded compelling evidence of the taxpayer's commitment to the plan before it will find that a firm and fixed plan existed."[13] Thus, taxpayers should be ready to show that, according to their understanding, the transactions were not a prearranged scheme of purportedly separate steps or in actuality a single transaction.

The step-transaction doctrine may be invoked under the end-result test only if the taxpayer intended a sole outcome when entering into a series of transactions and if no other outcome can be discerned. A taxpayer should not know and not be able to control what form the ultimate transaction will take so that the taxpayer does not have an intent to "reach a particular result."[14]

Furthermore, courts have held that the step-transaction doctrine may not be invoked under the end-result test where the form of the ultimate transaction is not known at the time of formation of the relevant entities. For example, in *Weikel*,[15] the Tax Court refused to apply the end-result test where the taxpayer formed a corporation and later exchanged the corporation's stock for stock of a publicly held company. The court found the test was not satisfied because at the time the corporation was formed, negotiations with the publicly held company were still in progress and it was not clear that the taxpayer's purpose in forming the corporation was to engage in a tax-free sale of the corporation's assets in exchange for the publicly held company's stock. The Tax Court accepted the taxpayer's testimony concerning why the corporation was incorporated, through notes, memos, or other written evidence.[16]

Each step, standing alone, should have economic significance and risk to withstand attack. Courts have indicated that the end-result test, like the interdependence test, applies only to "steps" that have no interdependent economic significance.[17] The limitation reflects the reality that the test cannot possibly be applied literally because, if it were, it would apply to all business transactions that, for purely business reasons, are consummated in segments.

The end-result test cannot be used to disregard ownership, even "transitory," by a true owner for tax purposes. This principle is confirmed by *Esmark*,[18] where the Tax Court respected arguably transitory stock ownership in the process of rejecting the IRS's attempt to apply the end-result test, because the taxpayer had all the "incidents of ownership" while it owned the stock at issue.

The existence of an overall plan alone does not mean the step-transaction doctrine will apply under the end-result test. With respect to tax-motivated transactions, the courts have refused to apply the step-transaction doctrine in several cases. The step-transaction doctrine was held not to apply to an otherwise qualifying Sec. 357 transaction, despite the existence of a prearranged plan to dispose of the stock representing control.[19] Perhaps the leading case in which a court held that the step-transaction doctrine did not apply to a tax-motivated transaction is *Esmark*. In that case, the Tax Court held that a taxpayer's form will be respected when each step has "permanent economic consequences," notwithstanding that reduction of taxes is a significant factor in structuring the transaction. The court rejected the IRS's attempt to apply the step-transaction doctrine to recast the transactions at issue, even though the transaction could have been accomplished differently.[20] The court said the "existence of an overall plan does not alone . . . justify application of the step-transaction doctrine."[21]

The IRS generally cannot reorder the steps actually taken or invent new steps just to create an additional tax liability.[22] As the Tax Court has stated, to collapse a transaction, the IRS must have "a logically plausible alternative explanation that accounts for ALL the results of the transaction."[23] In any event, the courts have limited the expansive scope of the end-result test, and case law strongly suggests that the courts are reluctant to reorder the actual steps taken by the parties or to invent new steps. In *Esmark*,the Tax Court refused to apply the step-transaction doctrine because it would require the addition of steps to the transaction that did not occur.[24] The IRS has agreed, at least under one fact pattern, that the step-transaction doctrine cannot be applied to reverse the order of the transactions.[25]

Interdependence test

The interdependence test asks whether "the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[26] Accordingly, the most important factor in determining if the step-transaction doctrine applies under this test is whether the transactions are so interdependent that none of the transactions would have occurred without the others. Thus, courts have held that even when two or more transactions are intended, and each transaction is planned before the first is consummated, the transaction may not be integrated if each transaction has substance by itself and has its own separate business purpose.[27]

The interdependence test looks at the relationship between the steps and whether one step would have occurred without the other steps. For example, in *Associated Wholesale Grocers*,[28] the court applied the interdependence test to integrate two purportedly independent transactions — a sale of a subsidiary's assets, followed by a repurchase by the parent of all those assets except the stock of a second-tier subsidiary — and denied the loss claimed on the asset sale, because the two agreements were, by their terms, dependent on each other. To avoid application of the step-transaction doctrine based on the interdependence test, each step in the transaction should have "reasoned economic justification standing alone."[29] Stated differently, the economic motivation supporting each individual transaction should be sufficiently meaningful on its own account and not be dependent on another transaction for its substantiation.

The interdependence test is generally applied where the transactions occur between related parties. For example, in *Kuper*,[30] shareholders of a realty-owning corporation contributed all their shares to an automobile dealership corporation owned by the same shareholders, which, in turn, made a cash capital contribution on the same day to the realty corporation. On the following day, the automobile corporation exchanged the realty corporation's shares for one stockholder's one-third ownership of the automobile corporation. The Fifth Circuit found that it was unlikely any one of these steps would have been undertaken except in contemplation of the others and were done to disguise a stock-for-stock transaction at the shareholder level. Therefore, the court treated the steps as a taxable exchange of stock.[31]

Binding-commitment test

The binding-commitment test, set out by the Supreme Court in *Gordon*,[32] is seldom applied by the courts.[33] It is the narrowest of the three step-transaction doctrine tests and typically favors the party that desires to have the separate transactions respected.[34] The binding-commitment test "is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny."[35]

In the foremost case applying the test, *McDonald's Restaurants*,[36] the court noted that the test was intended to deal with transactions that span several tax years and could have remained "not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen."[37] Under the binding-commitment test, "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps," otherwise, the step-transaction doctrine should not apply.[38] In addition, "if there were a moment in the series of the transactions during which the parties were not under a binding obligation, the steps cannot be collapsed under this test."[39]

Tax planning points

Taxpayers can have an overall plan in carrying out a series of transactions without running afoul of the step-transaction doctrine, but taxpayers should take actions to make sure that the doctrine cannot be successfully invoked by the IRS. To strengthen the position of transactions as independent transactions and withstand an IRS attack using the step-transaction doctrine, taxpayers should:

- Design each transaction so that it has substance by itself and has its own separate business purpose.
- Not have an agreement or understanding with other parties to the transaction to cause the actual result of the transaction in a prearranged plan.
- Not intentionally design the form of the transaction to reach a particular result.

- Not make a binding commitment at the time of the first transaction to complete the other transactions.
- Ensure there is economic motivation, significance, and risk for each transaction.
- Not undertake the transactions solely with related parties.
- Not attempt to disguise the economic reality of the ultimate result obtained by using multiple transactions.
- Be cognizant that transactions undertaken over a short period of time are more likely to be viewed as a single transaction with multiple steps.

A path to comfort

Taxpayers who know and understand the IRS's transaction challenge approach using the step-transaction doctrine should be more effective and efficient in their tax planning for transactions and whether to defend or settle upon a challenge of transactions. Only then can they feel comfortable in their tax planning that a series of transactions will withstand an IRS challenge.

Footnotes

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[1]*Penrod*, 88 T.C. 1415, 1428 (1987).

[2]*Jacobs*, 224 F.2d 412, 413 (9th Cir. 1955), citing *Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *Court Holding Co.*, 324 U.S. 331 (1945).

[3]Field Service Advice 1999-1095.

[4]*Kornfeld*, 137 F.3d 1231 (10th Cir. 1998), aff'g T.C. Memo. 1996-472.

[5]*Associated Wholesale Grocers, Inc.*, 927 F.2d 1517 (10th Cir. 1991).

[6]*Brown*, 782 F.2d 559 (6th Cir. 1986).

[7]See Notice 95-53.

[8]*King Enterprises, Inc.*, 418 F.2d 511 (Ct. Cl. 1969).

[9]*Smith*, 78 T.C. 350, 389 (1982).

[10]*Gordon*, 391 U.S. 83, 88 (1968).

[11]*Security Indus. Ins. Co.*, 702 F.2d 1234, 1244 (5th Cir. 1983), quoting *King Enterprises, Inc.*, 418 F.2d 511, 516 (Ct. Cl. 1969).

[12]*Long Term Capital Holdings*, 330 F. Supp. 2d 122, 191 (D. Conn. 2004).

[13]*Merrill Lynch & Co.*,120 T.C. 12, 53 (2003), aff'd in part, remanded in part, 386 F.3d 464 (2d Cir. 2004).

[14]*True*, 190 F.3d 1165, 1175 (10th Cir. 1999).

[15]*Weikel*, T.C. Memo. 1986-58.

[16]Id.

[17]*McDonald's Restaurants of Ill.*, 688 F.2d 520 (7th Cir. 1982).

[18]*Esmark, Inc.*, 90 T.C. 171, 195 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989).

[19]See, e.g., *Esmark*, 90 T.C. at 171; *American Bantam Car Co.*, 11 T.C. 397 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949).

[20]*Esmark*, *Inc.*, 90 T.C. at 196.

[21]Id. at 195-98.

[22]*Grove*, 490 F.2d 241, 247-48 (2d Cir. 1973), aff'g T.C. Memo. 1972-98 (citing S*heppard*, 361 F.2d 972, 972 (Ct. Cl. 1966)); see also *Esmark,* 90 T.C. at 196.

[23]*Turner Broadcasting System, Inc.*, 111 T.C. 315 (1998); see also *Del Commercial Props. Inc.*, 251 F.3d 210, 213-14 (D.C. Cir. 2001), aff'g T.C. Memo. 1999-411, and *Penrod*, 88 T.C. at 1428, 1430.

[24]*Esmark, Inc.*, 90 T.C. 171 (1988).

[25]Rev. Rul. 78-197.

[26]*King Enterprises*, 418 F.2d 511, 516 (Ct. Cl. 1969), quoting Paul and Zimet, "Step Transactions," *Selected Studies in Federal Taxation*, p. 254 (2d Series 1938).

[27]*Weikel*, T.C. Memo. 1986-58; *H.B. Zachry Co.*, 49 T.C. 73 (1967).

[28] *Associated Wholesale Grocers*, 927 F.2d 1517 (10th Cir. 1991).

[29] *Security Indus. Ins. Co.*, 702 F.2d 1234, 1247 (5th Cir. 1983).

[30] *Kuper*, 533 F.2d 152 (5th Cir. 1976).

[31] See also *True*, 190 F.3d 1165 (10th Cir. 1999).

[32] *Gordon*, 391 U.S. 83, 96 (1968).

[33] *Kornfeld*, 137 F.3d 1231 (10th Cir. 1987).

[34] *Andantech LLC*, T.C. Memo. 2002-97.

[35] Id.

[36] *McDonald's Restaurants of Ill.*, 688 F.2d 520 (7th Cir. 1982).

[37] Id. at 525, quoting *Gordon*, 391 U.S. at 96.

[38] *Redding*, 630 F.2d 1169, 1178 (7th Cir. 1980), quoting *Gordon*, 391 U.S. at 96.

[39] IRS, Coordinated Issue Paper, Distressed Asset Trust (DAT) Tax Shelters (March 23, 2010).

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